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IN THE

Supreme Court of the United States

OCTOBER TERM, 1948.

No. 151.

NATIONAL CARBIDE CORPORATION, *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

No. 152.

AIR REDUCTION SALES COMPANY, *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

No. 153.

PURE CARBONIC, INC., *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

REPLY BRIEF FOR THE PETITIONERS.

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COMMISSIONER OF INTERNAL REVENUE,
Respondent.

REPLY BRIEF FOR THE PETITIONERS.

I.

Applicable legal principle is undisputed.

The parties appear to be agreed as to the applicable law. Petitioners concur in the following statement of legal principle set forth in the Government's brief (p. 45):

> "The Commissioner does not at all negate the proposition that where a principal-agent relation-

ship exists, the principal's income is taxable to him, not to the agent, even though the money may pass through the agent's hands when collected by him for transmission to his principal. Nor is it denied that, in proper circumstances, a principal-agent relationship may exist between related corporations as it may between members of a family."

Specifically, the Government seems to concede (Br. 47) that "if the subsidiaries were acting as agents" of their parent, Airco, "the profits of the business were truly those of the parent as principal."

II.

The Courts below found the principal-agent relationship established.

The Government asserts (Br. 11): "There are no facts in this case which would permit the conclusion that the taxpayers were acting *as agents* for their stockholder, the parent company. *Nor did the Tax Court decide otherwise.*" (Italics ours.) It also states that the Tax Court did not hold that this was a case of "one corporation acting as an agent for another" (Br. 40).

The justification for these and similar statements is not clear. A striking indication of the weakness of the Government's position, however, is its failure to set forth and to explain or deal with the following clear and controlling finding of the Tax Court based upon all the evidence (R. 28):

"*Petitioners were the corporate agents of*

Airco and were operated as incorporated branches or divisions of Airco. The income from the operations of petitioners which is in excess of 6 per cent of petitioners' outstanding capital stock belonged to and *was the income and property of Airco as principal.*" (Italics ours.)

Moreover, the Circuit Court of Appeals expressed no disagreement with this finding; neither did it say that there was no evidence to support it. In its opinion, it expressly recited (R. 275) the contracts by which "The parent employed the subsidiary 'as its agent to manage and operate,'" and "'as its agent to market and sell.'" It also recited (R. 276) the above quoted finding of the Tax Court that "the subsidiaries were merely 'the corporate agents of Airco'" and that the income from their operations "'belonged to and was the income and property of Airco as principal.'" The Court simply failed, we think in error, to give legal effect to those findings.

Indeed, in our main brief (p. 15) we point out that the Circuit Court of Appeals has expressly recognized that the subsidiaries "were employed by the parent company as *its agents.*" (Italics ours.) *Railway Express Agency, Inc.* v. *Commissioner*, 169 F. 2d 193, 196. But the Government now seeks to minimize the statement by saying that it was merely a "dictum" written by Judge Clark "who did not participate in the present case" (Br. 44).

Clearly, however, that was a carefully considered statement made in a case involving a closely related issue. Although the opinion in the *Railway Express Agency* case was written by Judge Clark who did not participate in the decision in our case, it was con-

curred in by Judge L. Hand who wrote the opinion in our case, and by Judge Swan who concurred in the decisions in both cases.

Further, the Government conveys the erroneous impression that the principal-agent argument was not presented to the Circuit Court of Appeals or to the Tax Court. It asserts that the taxpayers "now argue" and have "only lately invoked" the principal-agent relationship as a basis for contending that the income belonged to Airco (Br. 40, 43). Inferentially the Government suggests that our argument is belated and should not be considered here.

Petitioners did unquestionably present that argument fully both in the Tax Court and in the Circuit Court of Appeals. That it was presented to the Tax Court is reflected in the findings and opinion of that Court, and in particular in its ultimate finding that the subsidiaries "were the corporate agents of Airco" and that the income and property belonged to Airco "as principal." Of pertinence also is the official headnote to the findings and opinion, prepared by the Tax Court, which we annex hereto as Appendix A.

That the argument based upon the principal-agent relationship was also presented fully to the Circuit Court of Appeals is evidenced by extracts from the index to our brief in that Court, set out in Appendix B to this brief. There is no basis, whatsoever, for any claim of surprise or "shift of ground" in this Court.

III.

The principal-agent relationship was fully supported by evidence.

The Government repeatedly asserts that the subsidiaries were not agents, and claims we have made "no attempt to document the conclusion" that the principal-agent relationship existed (Br. 45-46). The petitioners did not burden this Court with a detailed repetition of the evidence which the Tax Court had carefully weighed and evaluated. But ample evidence does support this finding.

The provisions of the contracts set out by the Tax Court, by the Circuit Court of Appeals, and by the Government itself (Br. 6-8, 46), show that Airco employed each subsidiary "as its agent" to manage and operate plants, and "as its agent" to market and sell the output of the plants.

In addition, the Tax Court's findings and opinion (R. 6-35) refer to numerous other facts establishing the agency relationship. These facts include, among others:

> All assets held by each subsidiary were furnished to it by Airco which paid for them with its own cash or stock (R. 31, 22). Title to over 850,000 gas cylinders, one of the most essential and valuable assets, costing nearly $13,000,000, was retained by Airco, which allocated them without charge to the agency companies as required (R. 27, 18, 21). Airco supplied all the working capital of each subsidiary (R. 31, 21).

The value of all assets held by the subsidiaries, the working capital supplied to them and the net proceeds of operations in excess of agency compensation were credited to the accounts payable by the subsidiaries to Airco and debited to the accounts receivable by Airco from each agency company. No interest ran on any of these accounts (R. 21-22, 27, 32).

There was substantial identity of the directors and officers of the subsidiaries and of Airco (R. 21-22, 30-31). The Airco Board held regular meetings and exercised complete domination and control over the business of Airco and each subsidiary (R. 23, 28, 31).

There was a single general office (R. 21, 23, 31). The business of Airco and its subsidiaries was conducted as one business unit, divided into six branches, and all employees in each of the six branches performed their duties for the parent and each agency company whenever and wherever their services could be utilized (R. 23, 31).

All expenditures for each agency company in excess of $50 required the approval of an officer of Airco, and expenditures for more than $500 required the specific approval of Airco's Board and its Chairman (R. 25, 31). When products produced by, or materials purchased for, one agency company were transferred to another, the transfer was made at cost, without the passage of any cash (R. 25, 31-32). All bank accounts in the name of each subsidiary were treated by Airco as its own, being drawn upon by Airco at will (R. 26, 32).

> The proceeds realized from each agency company's activities did not come to Airco as the result of any independent action by the agency company, such as a declaration of dividends (R. 32). The agency company's accounts were cleared monthly to Airco and all accounts were kept strictly in accordance with the agency agreements (R. 27, 32).

Thus the existence of the long standing principal-agent relationship was sustained by overwhelming evidence.

The Government says that if the relation of principal-agent existed, then (Br. 47) "It would have to follow that the losses would also be those of the parent." Actually, that was the situation here, and the contracts were so construed. During 1938, Airco had four subsidiaries, the three petitioners and Wilson Welder & Metals Co., Inc. The latter subsidiary showed a loss in 1938 and is not before this Court. The findings of the Tax Court, however, show that Airco bore this loss by a charge against it and a credit in favor of Wilson Welder in the amount of $90,940.74 (R. 11).

IV.

Airco was in every real sense the owner of all assets used in the production of income.

The Government repeatedly asserts that the subsidiaries "owned" the plants, machinery and other assets with which the business was conducted and that they used those assets and "earned" the income in question (Br. 2, 10, 12, 21, 22, 23, 24, 25, 27, 28, 29, 40, 47, 48). It makes only casual acknowledgment

of the fact that Airco at all times owned all the cylinders, a major asset costing approximately $13,000,000, which were used for containing and shipping gases (Br. 24).

We have shown (*supra*, p. 5) that Airco paid for and furnished to the subsidiaries all assets, working capital and all other instrumentalities used in the production of income. In every real sense, therefore, Airco was the owner of those assets although title to much of this property stood in the names of the subsidiaries. But "title" is not "ownership". A trustee does not own the property of which he has title for the benefit of others, and he is not taxed on the income produced by its use. Similarly, as here, an agent may have title to his principal's property without really being the owner of the property and without liability for taxes on income produced by its use.*

As this Court said in *Griffiths* v. *Commissioner*, 308 U. S. 355, 357-8:

> "We cannot too often reiterate that 'taxation is not so much concerned with the refinements of title as it is with the actual command over the property taxed—the actual benefit for which the tax is paid.' *Corliss* v. *Bowers*, 281 U. S. 376, 378. And it makes no difference that such 'command' may be exercised through specific retention of legal title or the creation of a new equitable but controlled interest, or the maintenance of effective benefit through the interposition of a subservient agency. Cf. *Gregory* v. *Helvering*, 293 U. S. 465."

* Cf. *Poe* v. *Seaborn*, 282 U. S. 101 at page 109.

V.

Southern Pacific Co. v. *Lowe*—"aptly descriptive".

The Government has dealt at length with *Southern Pacific Co.* v. *Lowe*, 247 U. S. 330, pointing out in great detail that it differs on the facts from this case. But, as we have said in our main brief (pp. 15-18, 20-21) the Tax Court regarded it, and we regard it as important primarily because it is "aptly descriptive" of the relationship between Airco and its subsidiaries, and because this Court gave legal effect to the agency principle.

VI.

No sham or tax evasion device is involved.

The Government also says (Br. 50) that tax results cannot "be altered by the simple expedient of adopting nomenclatures which do not aptly describe the true legal relationships among the parties." Similarly (Br. 49), it says that "here the parties have gone through the motions of calling each other 'principal' and 'agent'." These and similar comments seem to suggest that the contracts here involved and the whole relationship between the parties were a sham. Such assertions are not based on anything in the record or in the findings or opinion of the Tax Court or of the Circuit Court of Appeals.

Nor is there any merit in the Government's attempt arbitrarily to classify the agency agreements with instruments for the anticipatory assignment of income, made for purposes of tax-evasion (Br. 10, 11, 15, 26, 27). The cases cited by the Government as authorities in this connection all involve facts radically dissimilar

from those here presented. In all, a tax evasion or avoidance purpose is present.

The operations in the present case were pursuant to contracts which originated in 1917, and which have remained unchanged and in full force from their inception to the present time. They were not a tax evasion device. The Tax Court has accepted their validity and expressly found that (R. 28):

> "The method by which Airco conducted its business through corporate agencies was consistently adhered to and all details of the relationship between Airco and each of its corporate agencies or divisions were always fully disclosed to the Government and the Commissioner."

VII.

If the subsidiaries are deemed owners of the income, then the amounts payable to Airco are deductible expenses.

The Government contends that we seek, in the alternative, to have allowed as deductions to the subsidiaries not "the expenses incurred in earning their profits", but "the very profits themselves" (Br., p. 53). We do not ask that "profits" of the subsidiaries be held deductible expenses. The amounts which the subsidiaries are obligated to pay to Airco under their contracts can in no sense be regarded as "profits". If the Court of Appeals be correct in its decision, then these amounts are payable to Airco as necessary expenses of the subsidiaries because Airco furnishes them with all assets, working capital and other instrumentalities used in the production of income.

There is surely no reason why the subsidiaries should not pay Airco for the use of these instrumentalities if the income be regarded as the income of the subsidiaries. Such payments should be deductible by the subsidiaries as wholly proper payment for the use of Airco's property. Only the agency compensation of the subsidiaries under their contracts, remaining after such payment, would be "profits" to the subsidiaries.

Next, the Government asserts we are "improperly seeking to raise a new issue on appeal" (Br. 55). This is not so. As we have pointed out in our main brief (pp. 21-24) the question of deductibility was inherent in the issue presented in the Tax Court. But since the Tax Court sustained our contention that the income belonged to Airco the question of deductibility did not there expressly arise.

The question was presented, however, to the Circuit Court of Appeals on petition for rehearing (R. 284-8) because that Court had held that the income *belonged* to the subsidiaries. Then the question of deductibility, for the first time, became pertinent.

Conclusion.

If the decision of the Circuit Court of Appeals should be affirmed and the deficiency assessments sustained, the result would be most inequitable. As we have pointed out (Main Br. 7-8) the large net deficiency, after allowance for the Commissioner's finding of an over-payment of $545,134.45 in income tax by Airco, is almost wholly one of Declared Valu. Excess Profits Tax which the taxpayers might properly have avoided.

This claimed deficiency arises from the Commissioner's sudden change of position, for the first time in 1938, after many years during which he had full knowledge of all the facts. It resulted from attributing substantial income to the subsidiaries for whom only small capital stock tax declarations had been made, and, at the same time, withholding from the subsidiaries any benefit from the large capital stock tax declaration of Airco which was more than sufficient to cover all of the income of all of the companies.

The decision of the Circuit Court of Appeals should be reversed.

Respectfully submitted,

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APPENDIX A

Headnote in 8 T. C. 594

"THE TAX COURT OF THE UNITED STATES

NATIONAL CARBIDE CORPORATION, PETITIONER, v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.

AIR REDUCTION SALES CO., PETITIONER, v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.

PURE CARBONIC, INC., PETITIONER, v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.

Docket Nos. 5822, 5823, 5824. Promulgated March 25, 1947

Petitioners are wholly owned subsidiaries of a parent corporation organized in 1915. During the taxable year 1938 and for many years prior thereto petitioners operated under separate contracts with the parent to act as the parent's agent in managing, operating, and selling the products from the plants turned over to them by the parent for that purpose. Under these contracts the subsidiaries agreed to credit monthly to the parent all profits accruing from the operation of such plants over and above an amount equal to 6 per cent on their outstanding capital stock, which in the case of each subsidiary was a very nominal amount. The parent agreed to furnish all the necessary working capital and to provide such

executive management as might be necessary for the proper conduct of the businesses. Petitioners were operated as branches or divisions of the parent corporation. *Held,* the income earned under each of these contracts in excess of the 6 per cent of the outstanding capital stock of each subsidiary, respectively, belonged to and was the income of the parent corporation as principal, and was not, therefore, taxable to petitioners. *Southern Pac. Co.* v. *Lowe,* 247 U. S. 330, followed. *Interstate Transit Lines* v. *Commissioner,* 319 U. S. 590, distinguished."

APPENDIX B

Extracts From Index to Brief of Respondents in the United States Circuit Court of Appeals for the Second Circuit in the Case of *Commissioner of Internal Revenue* v. *National Carbide Corporation*, and Related Cases

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* * * *

"POINT ONE—The decisions of the Tax Court in these proceedings are based solely upon an ultimate finding of fact, fully supported by the evidence: That the income from the operations of the subsidiaries, apart from agency compensation, *belonged to and was the income and property of the parent as principal.*

Under the "Dobson Rule", and long established principles of appellate review, this determination must be accepted as conclusive on this appeal 22

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(Note: Italics have been added here.)